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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
125 East 93rd Street
New York City 28

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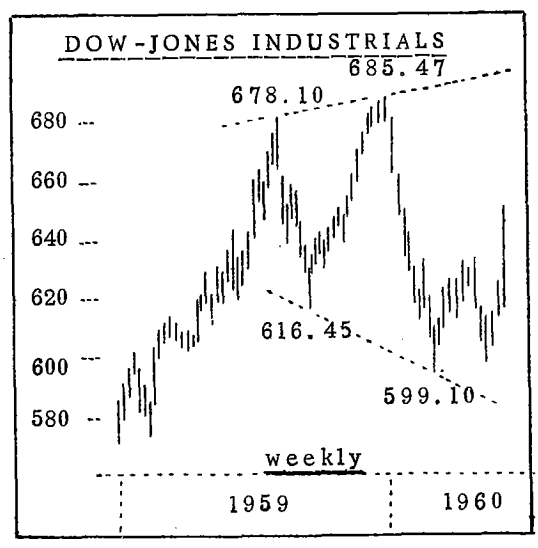
MARKET During the last month the Industrials have continued their advance, and since June 2 the movement has assumed the pattern of an almost vertical climb. Two things are of particular interest at this time. First, odd-lot ratios, having held in the area of 90 to 96 (nine shares sold for every ten purchased) actually switched on Monday (May 13) to selling on balance, and this is a factor (if it continues) of technical strength. Second, the character of the advance has been one of extreme selectivity with the greatest portion of the movement in the Industrial Average coming from six or eight "defensive" type stocks. For instance, the swing so far has advanced General Motors only two points -- a most unusual phenomenon. Thus the advance does not resemble the 1953-56 rise or the 1957-59 rise in which almost every stock on the board was swept upward by the bull tide.

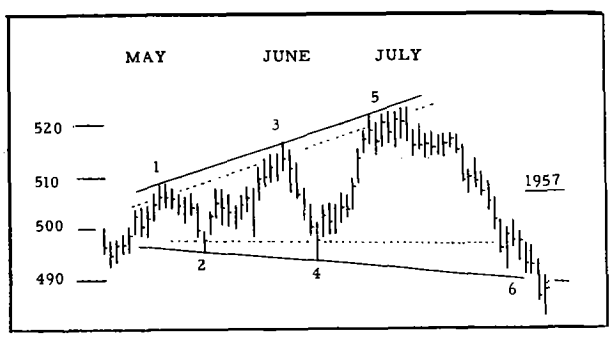
The current situation is most interesting. In my opinion, if Rails can better 146.56 (their secondary highs) the market might gather enough technical strength to take Industrials to or above their January, 1960, high of 685.47. A move by Industrials to 690-710 presents the fascinating picture (see weekly chart) of a possible gigantic broadening formation in the Industrial Average. Only time will tell whether such a formation will develop, but the nucleus of the classic broadening five-point reversal pattern has appeared. (A broadening formation suggests erratic, excited buying and selling and is usually seen at major tops).



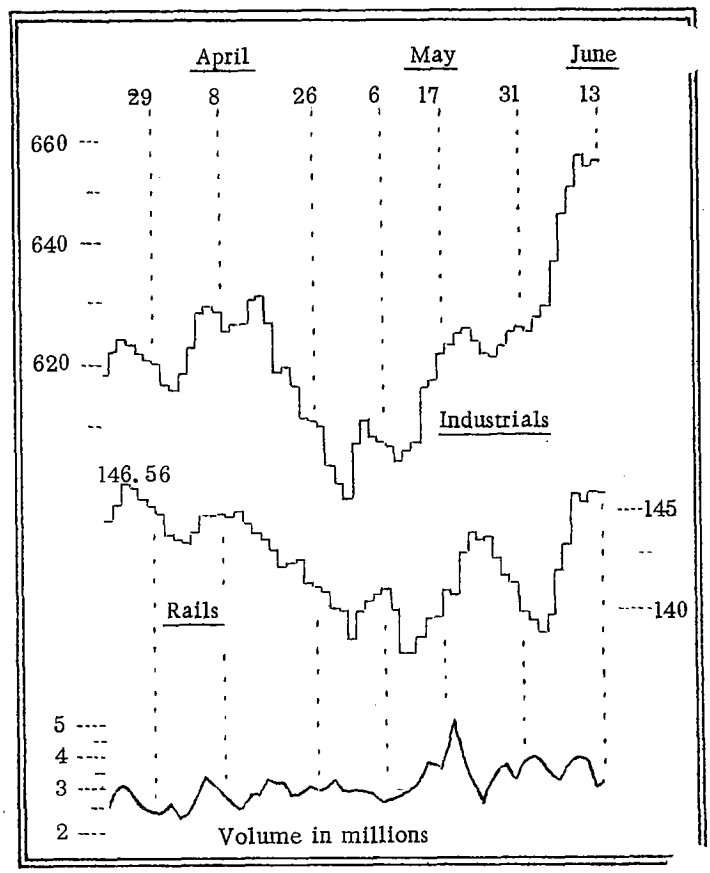
I have included a chart of the broadening top which occurred in 1957 prior to the July-October sell-off. Notice, however, that 1957 presented a small pattern which was apparent only on a daily chart. The current formation is huge and would be obvious only on a weekly chart. Although "formations" are not part of Dow's Theory, I discuss them when I believe they may provide insight into the market.

In the event of a Rail bettering of 146.56 (particularly if accompanied by increased volume) I would suggest covering all shorts. Conversely, a persistent refusal by Rails to better 146.56 could signal the end of the whole upward move.

SECONDARY OR NEW BULL MARKET? I have received a few letters inquiring as to whether the movement since July, 1959, was not merely a particularly involved secondary reaction in a continuing bull market (such as the reaction which occurred during 1957). In my opinion we are in a major bear market, and the primary trend of stocks and the economy continues down.



Bear markets serve to correct the excesses of the preceding bull market. The bull market of 1949-



1959 lasted ten years and advanced the D-J Industrials 525 points. The movement since July, 1959, does not qualify either in duration or extent as a correction of the preceding bull market. The following phenomena usually appear at bear market bottoms: (1) a mood of apathy or even hopelessness (top quality stocks are selling below known values, but nobody seems to care); (2) a period of low volume, dullness (at bear market bottoms volume is often 10% of that which appeared at the top); (3) low price-earnings ratios for common stocks; (4) high yields on common stocks, with stocks yielding considerably more than bonds.

It is obvious that none of the foregoing characteristics were exhibited at the lows of March or May, 1960. This brings us to the "secondary reaction theory". Arguing against this idea is the fact that a bear signal was given following a great primary upswing. At the peak of the upswing all the characteristics of a major bull market top were evident. "What would change your opinion about the bear market?" asks a correspondent. If Industrials better 685.47 and Rails better last July's high of 173.56 I will admit that either Dow's Theory gave a rare false signal or I was mistaken in my interpretation.

"Suppose that the two Averages do better their previous highs," ask the bulls; "of what use would Dow's Theory have been?" In answer I would say that it had signalled what might have been an immediate and disastrous collapse (March 3, 1960) and it had given early warning (August, 1959) of the fact that price levels were vulnerable. The great use of Dow's Theory as an investment tool is that it gives us a frame of reference. Admittedly the Theory cannot tell us exactly how to trade or what stocks to buy. But it can tell us when prices have outrun values, when the risk of holding equities is high and when a broad top is indicated. Conversely it can suggest that a major bottom has been reached and that stocks have overrun values on the downside.

Unfortunately, the Theory cannot show us how to "beat" the market on the minor or secondary movements. In fact Hamilton, one of the great market students, was opposed to the non-professional's speculating on the contra-tidal movements (as against investing with the primary trend.) Hamilton wrote, "...I am not advising any man to speculate, even if he has the moral stamina to comply with the same exacting requirements. If you have a business that you like, one which keeps you comfortable with a margin for the unforeseen, why speculate in stocks? I don't."

Rhea sold out in late 1928 and early 1929, well before the top. In 1934 he commented, "When the crash came in September-October, 1929, it was with considerable satisfaction that I realized that I had not been sucked into the whirlpool of frantic trading during the third phase of the great bull market." The Dow Theory does provide this type of advice and guidance, but with it must go, as Dow put it, "patience enough for six men."